

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of

1993 ANNUAL ACCESS TARIFF FILINGS

CC Docket No. 93-193

REPLY OF THE NYNEX TELEPHONE COMPANIES

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and
New England Telephone and
Telegraph Company

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The New York Telephone Company ("NYT") and the New England Telephone and Telegraph Company ("NET"), collectively the "NYNEX Telephone Companies" or "NTCs," hereby file their Reply to the Comments that were filed in response to their Direct Cases in this investigation.¹

I. INTRODUCTION AND SUMMARY

In their Direct Case, the NTCs demonstrated that (1) the \$12 million exogenous cost adjustment that they included to recover a modest portion of the NTCs' cost of implementing Statement of Financial Accounting Standards No. 106 (SFAS-106) was consistent with the Commission's rules; (2) they correctly normalized their 1992 rate of return for purposes of

¹ The NTCs filed their Direct Case on July 27, 1993. Comments were filed by the Ad Hoc Telecommunications Users Committee ("Ad Hoc"); Allnet Communications Services, Inc. ("Allnet"); American Telephone and Telegraph Company ("AT&T"); MCI Communications Corp. ("MCI"); and United and Central Telephone Companies ("United").

calculating their sharing obligation by removing the impact of lower formula adjustment ("LFA") revenues (referred to as "add-back" in the Commission's Designation Order²); (3) they reallocated general support facilities ("GSF") costs in accordance with the GSF order; and (4) they properly included line information database ("LIDB") per query rates in the Local Transport service category.

In their comments, several parties restated their objections to the NTCs' treatment of SFAS-106 costs, normalization of rates of return, and the categorization of LIDB rates.³ As the NTCs have demonstrated in the past and as they will demonstrate below, the objections of these parties have no merit. The following is a summary of the Reply of the NTCs to these comments.

SFAS-106 Costs. AT&T, Ad Hoc, Allnet and MCI continue to oppose the NTCs' \$12 million exogenous adjustment to recover a portion of the incremental impact of SFAS-106 on the costs of postretirement benefits other than pensions ("OPEBs"). This adjustment was limited to the transition benefit obligation ("TBO") and it only covered the additional costs for current retirees. The NTCs have met the FCC's two-prong test for exogenous treatment by demonstrating that the imposition of the TBO costs at issue is beyond their control; and that those

² In the Matter of 1993 Annual Access Tariff Filings, CC Docket No. 93-193, Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation, DA 93-762, released June 23, 1993.

³ No party has challenged the manner in which the NTCs allocated GSF costs.

costs are not double-counted in GNP-PI nor in rate of return, productivity or intertemporal factors.

The commenters base their objections on an overbroad and unreasonable control test which would effectively negate any exogenous adjustments under FCC price cap regulation. Also, those parties ignore or gloss over the detailed evidence submitted in this proceeding (e.g., the Godwins supplemental study) which resolves any concerns over potential double-count. Accordingly, the Commission should approve the NTCs' exogenous adjustment for OPEB TBO costs.

Add-Back. Several commenters argue that the Commission should not allow the local exchange carriers to apply add-back to LFA revenues. This position is inconsistent with (1) the Commission's rule on normalizing revenues for purposes of reporting rates of return; (2) the description of the backstop earnings mechanism in the LEC Price Cap Order.⁴ The commenters argue that applying add-back to LFAs would be retroactive ratemaking and that it would be contrary to the principles of rate of return enforcement as they existed prior to price caps. They refuse to accept the fact that the price cap backstop mechanism replaced the previous automatic refund rule. Moreover, their arguments go to the merits of the LFA mechanism, not to add-back. The price cap backstop mechanism is retroactive in nature regardless of whether the LECs apply add-back to the extent that it allows a prospective rate

⁴ Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990).

increase based on a past period rate of return. The Commission should not entertain these collateral attacks on the price cap backstop mechanism.

LIDB Rates. While there is a difference of opinion among the LECs concerning the service category into which the LIDB per query rates should be placed, most LECs agree that these rates should be in the Local Transport category. In any event, the Commission should not accept AT&T's suggestion that the Commission should establish a separate price cap service category for LIDB rates and for every other Part 69 switched access rate element. This would be a step backward to the rate of return regime and it would be contrary to the careful balance of pricing flexibility and ratepayer protection that the Commission reached in the LEC Price Cap Order when it established the current structure of baskets and service categories.

II. THE OPPOSITIONS TO THE NTCs' EXOGENOUS ADJUSTMENT FOR OPEB TBO COSTS ARE WITHOUT MERIT

A. Introduction

AT&T, Ad Hoc, Allnet and MCI oppose the NTCs' \$12 million exogenous adjustment to recover a modest portion of the incremental impact of SFAS-106 on OPEB costs. The NTCs' adjustment was limited to the TBO and only for current retirees. These parties contend that we have not met the FCC's two-prong test for exogenous treatment.⁵ These parties are

⁵ AT&T 1-19; Ad Hoc 1-12; Allnet 1-5; MCI 1-23.

incorrect. The NTCs have demonstrated that the imposition of the TBO costs is not within the NTCs' control and that the costs are not reflected in the price cap formula, e.g., GNP-PI.

B. Control

1. Scope Of Control Test

AT&T asserts (pp. ii, 11-12) that the NTCs have failed to show that the underlying OPEB TBO expense is not within our control and that we are not able to vary the level of OPEB benefits provided to employees.⁶ This assertion rests on the assumption that the NTCs may withdraw or curtail these benefits and therefore reduce the TBO costs. These parties' contentions distort the Commission's control standard for exogenous treatment, lack merit and should be rejected.

As a threshold matter, the NTCs note that AT&T's objection to the exogenous treatment of SFAS-106 expenses is disingenuous. AT&T previously requested exogenous treatment of its own SFAS-106 expenses on the basis that the imposition of such accrued expenses was beyond AT&T's control.⁷

⁶ See also Ad Hoc 4 n. 5; Allnet 3; MCI 4-5.

⁷ AT&T 1990 Price Cap Tariff Filing, Transmittal No. 2304, May 17, 1990, Transmittal Letter, p. 1 and Attachment, pp. 1, 14. In response to AT&T, the Commission stated: "The accounting change AT&T seeks to claim as exogenous [SFAS-106] will probably be mandated by FASB in 1992, and at that time qualify for exogenous treatment.... [E]xogenous costs [associated with USOA changes] can be either cost changes resulting from a change in [FCC] accounting rules or in any Commission-approved change in GAAP." AT&T, Transmittal No. 2304, Order by Chief, Common Carrier Bureau released June 27, 1990 (DA 90-878), para. 4. See also CC Docket No. 87-313, LEC Price Cap Order,

Further, in Docket 92-101, AT&T did not oppose in theory the exogenous treatment of LEC SFAS-106 costs; AT&T merely disputed the amount of cost recovery. Most recently, AT&T has sought to increase its price cap levels in respect of AT&T's own TBO costs.⁸

AT&T, citing to para. 53 of the FCC's OPEB Order,⁹ maintains that the control test is not met by the fact that the TBO costs were triggered by a change to accrual accounting mandated by the FASB and FCC.¹⁰ AT&T's citation is misplaced. The portion of the OPEB Order cited by AT&T addressed the exogenous treatment of ongoing OPEB costs, which are not involved in this proceeding. The Commission specifically decided to resolve the issue of whether LECs had control over TBO amounts based on the record in this proceeding.

In this regard, the record establishes that when all circumstances are considered, the NTCs lack control over the

⁷ (Footnote Continued From Previous Page)

released October 4, 1990, 5 FCC Rcd 7664, para. 168; LEC Price Cap Reconsideration Order, released April 17, 1991, 6 FCC Rcd 2637, paras. 59, 63; AT&T Price Cap Reconsideration Order, released February 8, 1991, 6 FCC Rcd 665, para. 75; CC Docket No. 92-101, Order of Investigation and Suspension released April 30, 1992, by the Chief, FCC Common Carrier Bureau, para. 6.

⁸ See AT&T Communications Tariff F.C.C. Nos. 1 and 2, Transmittal Nos. 5460, 5461, 5462 and 5464, CC Docket No. 93-193, Phase II, Order released August 10, 1993 (Common Carrier Bureau).

⁹ CC Docket No. 92-101, Order released January 22, 1993, 8 FCC Rcd 1024.

¹⁰ AT&T 6-7.

TBO costs at issue.¹¹ Thus, the accounting change was mandatory¹² and:

- The SFAS-106 standard itself compels some accrual of TBO costs;¹³ that standard expressly eschews a legalistic test.¹⁴
- The SFAS-106 prescriptions on actuarial assumptions significantly constrain our incurrence of TBO costs.
- On a practical level, we have no ability to cancel or significantly curtail the postretirement benefits involved, as acknowledged by AT&T (p. 10).
- Having been required to incur TBO costs, to the limited extent we could control the level of these costs, we have done so.¹⁵

Finally, the fundamentally flawed nature of our opponents' position on the control test is underscored by the fact that LECs have had some measure of control over the

11 NTC's Direct Case filed July 27, 1993, Exhibit 1, pp. 12-21.

12 The Commission should give great weight to the compulsory nature of the accounting change triggering incurrence of the incremental TBO costs at issue.

13 AT&T acknowledges (pp. 2 n. 5, 7) that SFAS-106 "requires" we book TBO amounts reflecting our "promise" to provide OPEB benefits.

14 Thus, contrary to the parties' suggestions (AT&T 7 n. 16; Ad Hoc 4 n. 5; Allnet 3; MCI 4), there need not be a legally indisputable inability to modify postretirement benefits, nor an explicitly clear ERISA right of retirees to OPEBS.

15 AT&T (pp. 11-12) and MCI (p. 5) wrongly contend that our cost-containment efforts show control which should negate exogenous treatment. The parties miss the decisive point that the TBO costs we have presented herein cannot be controlled or curtailed further. Certainly, we should not be penalized for aggressive cost-containment measures.

underlying costs of all items eligible for exogenous treatment. Our opponents' position taken to its logical conclusion would improperly deny exogenous treatment in every case and in effect negate the Commission's rules in this area.¹⁶

2. OPEB TBO Expense Compared To Certain Endogenous Cost Items

AT&T tries to liken the TBO costs at issue to certain other cost items treated endogenously by the FCC (e.g., depreciation, international settlements, etc.)¹⁷ However, we have shown OPEB TBO costs to be quite distinct from such items¹⁸: GAAP/USOA changes have previously been explicitly classified by the FCC as eligible for exogenous treatment; the mandated accounting change has triggered the incurrence of costs outside our control (see supra); because GAAP changes are industry-wide and well-publicized, LECs do not have the ability to pick and choose those changes based on whether they increase or decrease costs; and exogenous treatment of OPEB TBO costs fully comports with the incentive structure of price cap regulation (see next section).

¹⁶ See NTC's Direct Case filed July 27, 1993, Exhibit 1, pp. 14-16.

¹⁷ AT&T 7 n. 15, 11 & n. 23.

¹⁸ NTC's Direct Case filed July 27, 1993, Exhibit 1, pp. 14-16, 18-19; NTCs' Reply filed May 10, 1993 regarding 1993 Annual Access Tariff Filings, Appendix B, pp. 5-7, 18-20; NTCs' Reply Comments in Docket 92-101 filed July 31, 1992, pp. 15-19.

3. Price Cap Incentive Structure And Backstop Mechanisms

AT&T incorrectly maintains that exogenous treatment of the OPEB TBO costs would be inconsistent with the incentive structure of the price cap plan.¹⁹ We have shown that to the contrary, exogenous treatment will advance the Commission's price cap policies.²⁰ Among other things, exogenous treatment of such GAAP changes is warranted to ensure that the price cap plan does not lead to unreasonably high or unreasonably low rates; GAAP changes cannot be arbitrarily selected for exogenous treatment depending upon the direction of the cost change; we have already minimized the TBO accrual and efficiency incentives are preserved in all events.

AT&T also opposes the LECs' exogenous adjustments on the view that some price cap LECs have enjoyed earnings high enough to trigger sharing and the low end adjustment is available in any case to guard against low earnings.²¹ AT&T's arguments misapprehend the FCC's price cap system.

The price cap plan provides for a low end adjustment if a LEC's earnings fall below 10.25% in a base year period. This adjustment serves to ensure that the price cap plan does

¹⁹ AT&T 4-5, 7 n. 16, 12-13 & n. 20; see also MCI 3, 5.

²⁰ NTC's Reply filed May 10, 1993, supra, Appendix B, pp. 22-24.

²¹ AT&T 18-19; see also Allnet 3 (arguing that denial of exogenous treatment would not be an "unlawful taking" and would still permit price cap LECs to earn a minimum authorized rate of return).

not impair a LEC's ability to provide quality service to its customers.

Under price cap regulation, the NTCs have not made any sharing or low end adjustments that reflect the impact of SFAS-106. In any case, the low end adjustment and sharing mechanisms are irrelevant to whether OPEB TBO costs should be treated as exogenous. Neither the LEC Price Cap Order nor the Commission's prior treatment of exogenous cost changes lend any support to the notion that the need for an exogenous cost adjustment depends on the effect of the exogenous event on low end or sharing adjustments.

The low end adjustment and the sharing zones are designed to provide a backstop on low earnings to prevent unreasonably low rates, and to provide a cap on high earnings to prevent unreasonably high rates.²² Exogenous cost changes, on the other hand, are adjustments to the price cap indices for changes that would not be incorporated in the productivity or inflation factors. Therefore, such cost changes are necessary to provide the proper incentives for LECs to meet or beat the productivity standards.

Regardless of whether a LEC's earnings are in the sharing, no sharing or low end adjustment zones, the LEC is entitled, and in some cases, required, to make an exogenous cost adjustment for "costs that are triggered by administrative, legislative, or judicial action beyond the

²² See LEC Price Cap Order paras. 144-150.

control of the carriers."²³ For example, LECs have been required to reduce PCIs for expiration of amortization of depreciation reserve deficiencies regardless of whether the rate decrease would push the carrier's earnings below the low end adjustment mark. Conversely, an exogenous cost increase is justified even if it would increase a LEC's earnings and place it in the sharing zone.

Moreover, if the FCC had intended for the low end adjustment and sharing mechanism to address exogenous cost changes, there would have been no need for the Commission to promulgate the exogenous component of the price cap formula and the list of presumptively exogenous items set forth in Section 61.45(d) of its Rules.

C. Double-Count Issues

1. GNP-PI

The parties contend that the NTCs we have not shown that the exogenous treatment of TBO costs would not result in a double-count (because such costs are arguably recovered in the GNP-PI element of the price cap formula).²⁴ The parties simply gloss over or ignore the supplemental study by Godwins which fully addressed and resolved the concerns previously identified by the Commission.²⁵ The Godwins studies show

²³ Id. para. 166.

²⁴ AT&T 14 n. 30; Ad Hoc 4-5; Allnet 4-5; MCI 5-6, 12.

²⁵ See NTCs' Direct Case filed July 27, 1993, Exhibit 1, pp. 22-23.

that SFAS-106 has a disproportionate effect on price cap LECs such that the vast majority of additional costs from the accounting change are not captured in the GNP-PI part of the price cap formula.

Ad Hoc states that (p. 5):

Indeed, the shortcomings of the supplemental Godwins study were made clear in the Designation Order [para. 29]: "The record concerning double-counting in the GNP-PI has been enhanced by a second Godwins study. However, other potential areas of double counting discussed in the OPEB Order have not been sufficiently addressed." [Emphasis added by Ad Hoc.]

By this statement, Ad Hoc suggests that the Commission considered the Godwins supplemental study to be flawed because it does not address the "other areas of potential double-counting." Ad Hoc misrepresents the Designation Order on this point. The Order explicitly stated that the other potential areas of double-counting relate to intertemporal considerations, rate of return and productivity factor, areas not involved in the Godwins studies which focused on GNP-PI. The Commission found Godwins enhanced the record on GNP-PI, and we have sufficiently addressed the other alleged double-count areas through other evidence.

2. Intertemporal Considerations

AT&T argues that exogenous treatment of the TBO costs involved here is unwarranted because the price cap formula will provide for full cost recovery over time.²⁶ In addition, the

²⁶ AT&T 13-18, Appendix B-2. See also Ad Hoc 6-7; Allnet 3; MCI 5-6, 10-13.

commenters assert that the TBO costs are not economic costs, but are merely accrued expenses; and that the timing of cost recovery is irrelevant to determining the propriety of exogenous treatment.

The NTCs have previously addressed this issue and shown that our exogenous adjustment is fully consistent with intertemporal considerations.²⁷ The NTCs have offered to subtract each year the GNP-PI minus productivity impact on the amortized TBO accruals at issue. This would be in line with the fact that those TBO accruals are fixed and in effect constitute a true-up with respect to retirees' past service. Further, after the TBO amortization is completed, presumably an exogenous adjustment would be in order to remove the costs (similar to expiration of depreciation reserve amortization). These adjustments should dispose of any intertemporal concerns.

It bears emphasis that the timing of cost recovery is important and central to the rationale of SFAS-106 accounting as adopted by the FASB and FCC. Our opponents simply ignore that rationale. SFAS-106 represents the view that OPEB costs should be recognized as they accrue from related service rather than when they are paid. That is, present ratepayers are appropriately expected to fund benefits of employees and retirees who have worked to provide them with services.

²⁷ NTCs' Direct Case filed July 27, 1992, Exhibit 1, pp. 23-24; NTCs' Reply filed May 10, 1993, Appendix B, pp. 14-15, 17-18; NTCs' Reply Comments in Docket 92-101 filed July 31, 1992, p. 9.

AT&T submits a numerical Appendix (B-2) purporting to show that the dollar amount of pay-as-you-go expenses and OPEB TBO expenses are equal over time. But AT&T's illustration of the intertemporal double-count over time in Appendix B-2 could only hold true under unrealistic assumptions about medical trend rates, a closed retiree population (no additions or subtractions from the group for thirty-plus years), and for nonregulated firms that have the freedom to adjust prices and revenues in order to offset current expenses. Under these restrictive conditions, the present value of the expected pay-as-you-go amounts and the expected SFAS-106 accruals would be exactly equal, and the timing of the costs and revenues is irrelevant. This does not hold true for the NYNEX Telephone Companies and other price cap LECs because the timing of revenue/expense streams must be made approximately equal. It is not sufficient, as AT&T suggests, to simply allow thirty years to pass before all TBO costs may be eventually recovered through the price cap formula. Moreover, if the Commission were to adopt AT&T's suggestion, it would constitute a clear abdication of its decision to recover current expenses from present ratepayers.

3. Rate Of Return

Ad Hoc and MCI again conjecture, without evidentiary support, that the effects of SFAS-106 may be double-counted in the FCC-prescribed interstate rate of return.²⁸ These

²⁸ Ad Hoc 8-11; MCI 13-14. We note that AT&T has dropped this tenuous argument.

parties fail to recognize that the FCC did not and could not have considered SFAS-106 costs in the last interstate rate of return prescription (CC Docket No. 89-624); those costs were not known to the FCC or anyone else (including investors)²⁹ in that time frame; there is absolutely no evidence that the stock market discounted the impact of SFAS-106 (i.e., leading to lower share prices and a higher rate of return based upon Discounted Cash Flow [DCF] calculations).³⁰ Indeed, in another context, AT&T acknowledges the latter point (at p. 14 n. 19) where AT&T quotes from Moody's March 1991 Special Comment on SFAS-106, p. 3: "We must recognize that the new reporting, as it involves accrual accounting, is not expected to change our assessment of the prospective cash flow of companies."

MCI refers to p. 27 n. 42 of Exhibit 1 of our July 27, 1993 Direct Case regarding a study by Mittlestaedt and Warshawsky³¹ showing that the impact of SFAS-106 on stock prices could not be determined. MCI asserts that (p. 13): "NYNEX, however, cites merely from an abstract of the original study, and ignores the actual findings of the study." This assertion by MCI is absurd. The very first page of the

²⁹ See MCI 13 (referring to "largely unknown SFAS-106 liabilities").

³⁰ See NTCs' Direct Case filed July 27, 1992, Exhibit 1, pp. 24-28; NTCs' Reply filed May 10, 1993, Appendix B, pp. 15-16; NTC's Reply Comments filed July 31, 1993 in CC Docket No. 92-101, pp. 20-26.

³¹ H. Fred Mittlestaedt and Mark Warshawsky, "The Impact Of Liabilities For Retiree Health Benefits On Share Prices", Federal Reserve Board, Washington, D.C., April 1991.

Mittlestaedt and Warshawsky study contains language virtually identical to the language in the abstract that we quoted in the Direct Case, including the following point:

The results show that the market is aware of corporate liabilities for retiree health benefits. There is, however, a high degree of imprecision surrounding the estimates of the liabilities. To the extent that the imprecision is due to lack of disclosure, the results are consistent with observing significant price adjustments, upward and downward, upon the release of the information under the new accounting standard. [Emphasis added.]

In any case, MCI concedes (p. 14) the critical point that the "impact of a one for one reduction in market valuation did not occur." However, MCI goes on to make the false statement that (p. 14): "There was no question, however, that the effect of SFAS-106 on share prices was of the correct direction and a reasonable magnitude." Again, Mittlestaedt and Warshawsky concluded that the impact on stock prices even in terms of overall direction could not be determined. MCI also contradicts itself by acknowledging that (p. 14) the Mittlestaedt and Warshawsky study "provides evidence ... that SFAS-106 would leave share prices unaffected."

Finally, in a footnote (p. 14 n. 22), MCI makes the puzzling and incorrect statement that "investors could reasonably expect that long term earnings growth would be relatively unaffected, thereby causing share prices to decline under the DCF methodology." As indicated, however,³² since

³² NTCs' Direct Case filed July 27, 1993, Exhibit 1, pp. 26-27.

all expected SFAS-106 to reduce earnings,³³ the growth factor in the DCF formula would decrease, putting downward pressure on the rate of return. As Ad Hoc concedes (p. 10 n. 16):

Although the SFAS-106 charge-offs had no effect on corporate cash flows and barely effected [sic] the stock market, without the new rule, reported earnings would have risen to \$70.5 billion -- 17.5% better than comparably adjusted figures for 1991. Fortune, April 19, 1993, at 174-175. Thus, the impact of the SFAS-106 rule on reported profits was large in an accounting sense, but was not reflected in stock price movements.³⁴

* * * *

In closing, two miscellaneous issues should be briefly addressed. First, Ad Hoc at 11-12 suggests that SFAS-106 amounts were already subsumed in price cap productivity factors. MCI at 14 merely alleges with zero substance that the NTCs have not offered a "full and reasoned analysis" on other potential double-counting issues such as productivity factor. These parties have totally ignored the NTCs' demonstration that there is no double-count associated with the price cap

³³ See also Mark J. Warshawsky, "Postretirement Health Benefit Plans: Costs And Liabilities For Private Employers," Board of Governors of the Federal Reserve System, Washington, D.C., May 1989, Abstract by Warshawsky ("It is expected that the proposed changes in accounting standards for postretirement health benefit plans sponsored by corporate employers would have a significant negative impact on reported profits and on the reported net worth of corporations.")

³⁴ Ad Hoc goes on in that footnote to infer the totally baseless and facile speculation that the interstate rate of return would have already reflected a downward impact in respect of SFAS-106.

productivity factor.³⁵ Among other things, we indicated that the productivity factor resulted from the FCC's judgment applied in an upward direction without regard to any SFAS-106 type costs, which were inconsequential in any case.³⁶

Second, AT&T in a footnote (p. 3 n. 8) reiterates its argument (from its April 27, 1992 Petition regarding 1993 Annual Access Tariff Filings) that inclusion in rates herein of SFAS-106 costs for the first half of 1993 is contrary to the rule against retroactive ratemaking. AT&T's argument is substantively without merit, as we showed in our May 10, 1993 Reply (Appendix B, pp. 24-25). Furthermore, AT&T's argument is procedurally improper. In permitting the revised access rates to become effective July 1, 1993, the Commission implicitly rejected AT&T's retroactive ratemaking contention. Since the Commission did not designate that issue for investigation, AT&T's present argument is tantamount to an untimely petition for reconsideration of the Designation Order. Such a request for reconsideration would be clearly improper in any case where AT&T offers nothing new but merely reiterates an argument previously presented and rejected.

³⁵ NTCs' Direct Case filed July 27, 1993, Exhibit 1, pp. 29-30; NTC's Reply filed May 10, 1993, Appendix B, p. 16.

³⁶ The fact that AT&T has dropped the productivity argument reflects how weak that argument is.

D. Conclusion

The Commission should approve the NTCs' exogenous adjustment for OPEB TBO costs which fully accords with the Commission's rules.

III. THE COMMISSION'S RULES REQUIRE THE LOCAL EXCHANGE CARRIERS TO CALCULATE THE SHARING AND LFA ADJUSTMENTS TO THEIR PRICE CAP INDICES BY NORMALIZING THEIR CURRENT PERIOD RATES OF RETURN THROUGH ADD-BACK

Allnet agrees with the NTCs that the current rules require the LECs to normalize their rates of return for purposes of computing sharing or LFA adjustments to their price cap indices by adding-back the effect of prior year sharing or LFA adjustments.³⁷ MCI and Ad Hoc believe that add-back is required for sharing amounts but not for LFAs.³⁸ However, AT&T recognizes that if add-back is required, it must be applied consistently for both sharing and LFA amounts.³⁹

The positions of MCI and Ad Hoc are obviously one-sided and self-serving. If add-back is necessary to properly reflect base year earnings, it must be applied equally to sharing and LFA amounts. In their efforts to convince the Commission to adopt a patently unfair interpretation of its

³⁷ See Allnet at pp. 5-6. Allnet also notes that the Commission's recent Notice of Proposed Rulemaking ("NPRM") in Docket 93-179 proposes to clarify the fact that add-back is required by the existing price cap rules. Id., citing Rate of Return Sharing and Lower Formula Adjustment, CC Docket No. 93-179, Notice of Proposed Rulemaking, FCC 93-325, released July 6, 1993.

³⁸ See MCI at pp. 23-32; Ad Hoc at pp. 12-24.

³⁹ See AT&T at p. 24 n.51.

rules, MCI and Ad Hoc rely upon a simple mistake in logic. They begin with the Commission's statement in the NPRM that add-back was required by the rules that existed under the rate of return regime for reporting earnings levels and that the Commission did not change this requirement when it adopted its price cap rules. They proceed from this point to argue that add-back should not apply to LFA amounts under price caps because it would be inconsistent with principles of rate of return enforcement, which required refunds of overearnings but which did not allow for rate increases for underearnings in prior periods.⁴⁰ The second proposition does not follow from the first. To be sure, the Commission retained the rule from the rate of return regime that the LECs must report earned, or normalized, revenues by adding back refund amounts and by removing the effect of revenues earned in prior periods. But when the Commission adopted the backstop earnings mechanism in the LEC Price Cap Order, it abandoned the rate of return rules on automatic refunds. Those rules no longer apply to price cap LECs. Although the commenters' nostalgia for a system that required refunds of overearnings and no relief for underearnings is understandable, there is no way for the Commission to adopt their position without directly contradicting the explicit findings of the LEC Price Cap Order.

⁴⁰ See MCI at p. 27; Ad Hoc at p. 21. MCI notes that the automatic refund rule that preceded the price cap system did not allow for LFAs and did not guarantee that the LECs would earn a minimum rate of return. Therefore, there was no occasion under the previous system for the LECs to add-back the effects of rate increases due to underearnings in prior periods.

MCI's inability to accept the reality of the price cap rules is evident. MCI states that "LFA add-backs effectively insulate price cap LECs from earnings below a 10.25 percent rate of return under price cap regulation--a guarantee which is tantamount to retroactive ratemaking and not provided under rate of return regulation."⁴¹ That is right. The rate of return regime had no lower limit on earnings. However, the LEC Price Cap Order makes it perfectly clear that the LFA mechanism was designed to provide relief for a LEC earning below 10.25 percent through a prospective increase in rates. And, as MCI admits, add-back is essential to enforce that lower limit. MCI wants the price cap backstop mechanism to operate "in the same way as rate of return enforcement does under rate of return regulation."⁴² This is impossible--the two systems are fundamentally different and cannot be reconciled.

When MCI complains that add-back of LFAS would be tantamount to retroactive ratemaking, it fails to recognize that the LFA is computed on a retroactive basis regardless of whether a LEC includes add-back in its rate of return calculations. An LFA is always calculated on the basis of past period earnings, without regard to the earnings level that the LEC expects to earn in the future. As the Commission noted in the NPRM, add-back does nothing more than ensure that sharing and LFA amounts are consistent with the original intent of the price cap rules. In opposing add-back for LFAS, MCI is

⁴¹ MCI at p.27.

⁴² Id.

attempting to reargue the premise for the LFA mechanism itself. Similarly, when Ad Hoc argues that incorporating add-back of LFAs would "reward poor performance" and eliminate incentives to improve productivity,"⁴³ it is attacking the LFA mechanism, not just add-back. These collateral attacks on the price cap rules are irrelevant to the issues in this investigation.

Ad Hoc tries to justify applying add-back to sharing but not to LFAs by arguing that sharing is retroactive but that LFAs are prospective.⁴⁴ This is clearly wrong. LFAs were never designed to allow the LEC to earn a particular rate of return in the future. Both sharing and LFA amounts are based on base period rates of return. There is no rational basis for applying add-back differently for sharing than for LFAS.

MCI argues that add-back of LFAs "permanently excludes revenues from LFA rate increases from ever being included in the calculation of base earnings."⁴⁵ As the NTCs explained in their Reply Comments in Docket No. 93-179, add-back properly accounts for all revenues. Although the LECs do not retroactively modify their base year rate of return reports for LFA amounts that are received in the next year but which are excluded from the rate of return reports through add-back, their total revenues for the base year and the subsequent year are correctly reflected in their booked rate of return

⁴³ Ad Hoc at p. 24.

⁴⁴ Ad Hoc at p. 22.

⁴⁵ Id.

calculations. If the LECs recalculated their base year rates of return to include LFA amounts, their rates of return for the base year would be up to, but no higher than, the 10.25% lower limit, which is the intent of the LFA mechanism.

AT&T argues that LFA amounts should not be removed from the the LECs' revenues for purposes of calculating their rates of return because the Commission did not require this calculation when it modified the Form 492.⁴⁶ AT&T notes that the previous Form 492, which the Commission adopted under the rate of return regime, included a line requiring the LECs to add-back the effect of refunds applicable to past period overearnings. In the new Form 492A, the Common Carrier Bureau required the LECs to show refunds and sharing/LFA amounts on separate lines, but it did not include a line where these amounts would be reflected in the rate of return calculations. However, the Bureau did not revise the language on the back of the form that requires the LECs to report earned, i.e., normalized revenues on the Form 492A. The LECs report earned revenues by adding-back the effect of refunds and credits for prior period overbillings, and by removing the revenues associated with backbillings and with services provided in prior periods, such as LFAs. Since the new form does not have a separate line for this computation, it must be included in the total revenues on line 1. This is how the LECs have filled out the new form with regard to refunds, and it applies equally to all other out-of-period adjustments to revenues, such as

⁴⁶ See AT&T at pp. 23-24.